United States Court of Appeals

for the Second Circuit

AMICUS BRIEF

75-1004

United States Court of Appeals

FOR THE SECOND CIRCUIT

UNITED STATES OF AMERICA,

Appellee,

v.

ANTHONY M. NATELLI and JOSEPH SCANSAROLI,

Defendants-Appellants.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF ON BEHALF OF PEAT, MARWICK, MITCHELL & CO., *AMICUS CURIAE*

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GEORGE WAILAND

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This brief is submitted on behalf of Peat, Marwick, Mitchell & Co. ("PMM") as *amicus curiae* in support of the appeals of Anthony M. Natelli and Joseph Scansaroli.

The interest of PMM in these appeals is set forth in the affidavit in support of PMM's motion for leave to file this brief, a copy of which is printed as the appendix hereto.

The lack of evidentiary support for and the erroneous instructions and rulings which led to appellants' convictions are detailed in the briefs submitted by their counsel. We wish only to stress two errors in the instructions of the trial court which, unless corrected by this Court, will, we believe, have a material, adverse and unwarranted impact upon the practice of the profession of accountancy. Other errors aside, the trial court:

1) refused to instruct the jury concerning the different responsibilities of an independent accountant in connection with audited and unaudited financial statements; and

2) failed to instruct the jury to consider whether the accountant's professional judgment of immateriality, even if erroneous in objective terms, was honestly made.

ARGUMENT

1. The trial court's charge in a number of places used the words "audited" and "unaudited". The court declined, however, to give any explanation to the lay jury beyond such as might be found in the words themselves. (Tr. 2384). In describing the duty of an independent accountant, the court lumped together the audited and unaudited information in one instruction:

> "An auditor must ascertain that the financial statements in question, such as the figures [the nine-months unaudited figures] or the footnote [to the earlier audited financial statements] fairly present the results of operations and the financial position of the company." (Tr. 2369; *see also* 2397-98; 2367).

In a trial which dealt so much with the claimed inadequacies of the 1968 audit, the jury could not have understood the important distinction in character between the two alleged misstatements in the 1969 proxy statement which the trial court refused to explain.

The significant basis to the Government's charge with respect to the nine-months unaudited financial statements was the inclusion within them of the Eastern Airlines' com-

mitment, evidenced by the apparently binding letter of a responsible Eastern Airlines official. Although Mr. Natelli did not immediately take a position with respect to the commitment when this letter was made available to him and went further to inquire into the work done by NSMC in connection with the program which was the subject of the commitment, he did not at that time obtain a direct confirmation of the validity of the commitment from Eastern Airlines. An independent accountant would not in connection with unaudited financial statements follow the audit step of obtaining confirmations from customers of the company. There was much testimony, however, concerning allegedly inadequate confirmations in connection with the 1968 audit and the confirmation procedures to be followed in connection with the 1969 audit. Absent a proper instruction concerning the difference between the auditor's function in connection with audited and unaudited statements, prejudicial confusion in the minds of the jurors was inescapable. The trial court's failure to give such an instruction was prejudicial error.*

The trial court's error reflected, we fear, a fundamental misunderstanding, or at best a gross oversimplification, of the role of the independent accountant as it has been and is understood by the accounting profession. We do not suggest that the generally accepted accounting principles and auditing standards of the profession are necessarily defenses to a charge of conscious falsehood; that is not the

* This prejudice was aggravated by the trial court's instruction with respect to "reckless disregard". This instruction taken together with the absence of explanation concerning "audited" and "unaudited" could only have pointed the jury to a finding of guilt from failure to follow in an "unaudited" situation, a procedure of which the jury had heard much proof in the context of "audited" financial statements. *United States* v. *Fields*, 466 F.2d 119, 120 (2d Cir. 1972).

argument. Rather, we submit that those who after the fact judge the conduct of an accountant must understand that an accountant may be called upon to perform different services in different circumstances and that his conduct should be measured against the particular responsibility he has undertaken.

When an accountant makes an examination of a company's financial statements and expresses an opinion concerning the fairness of their presentation—when he conducts an audit—he gives credence to that opinion by his name and status as an independent professional. The pronouncements of his profession require that he conduct auditing tests and apply accounting principles which are appropriate to the circumstances. He knows that his client is entitled to expect a reasonable measure of such professional competence, and others, depending on the circumstances and the precedents from this and other courts, may be entitled to the same expectation.

The independent accountant may be also asked to perform services which do not entail the issuance by him of an opinion and the creation of the expectation to which we have referred. His knowledge of financial statement format permits him to assist a company in properly categorizing and presenting figures for the accuracy of which the company alone can and does vouch. When such company-assembled and unaudited figures are presented in a proxy or registration statement, the company's responsibility is stated just as it was in the NSMC proxy statement at issue:

> "With respect to the nine month periods ended May 31, 1968 and May 31, 1969, which are unaudited, the management of the Corporation believes that all adjustments (none of which were other than normal recurring accruals) necessary to a fair statement of results

for such interim periods have been included." (GX 25, p. 21).

Another party—the underwriters of a public offering of securities or in this case the other party to a merger—may seek some measure of negative assurance from the independent accountant—"cold comfort" as it is called. Here again, the limited extent of the accountant's responsibility and of the techniques to be applied is made clear as it was in the Interstate merger agreement included in the proxy statement:

> "Interstate shall have received a letter, satisfactory to it, from Peat, Marwick, Mitchell & Co. to the effect that on the basis of a limited review, but not an audit, of the latest available unaudited interim financial statements of NSMC and its subsidiaries, consultations with responsible officers of NSMC and other specified procedures and inquiries (including all such procedures as they consider necessary under the circumstances in connection with such limited review), they have no reason to believe that the unaudited interim financial statements of NSMC as of May 31, 1969, and for the nine months then ended, were not prepared in accordance with accounting principles and practices consistent with those followed in the preparation of the August 31, 1968 audited financial statements or that any material adjustments of such unaudited interim financial statements are required for a fair presentation of the results of operations of NSMC and its subsidiaries . . . ." (GX 25, Schedule C, pp. 14-15).*

* This "limited review, but not an audit" was to be performed shortly before the closing of the Interstate merger on October 31, 1969. By then, the 1969 audit was in progress and had developed the adjustments stated in the letter which disclaimed comfort.

The role and responsibility of the independent accountant in connection with unaudited financial statements is fundamentally different from his role and responsibility in connection with audited financial statements, but this difference was not meaningfully explained to the jury by the mere use of the words "audited" and "unaudited".

It may be that independent accountants will be asked to assume greater responsibilities for company figures, such as regularly announced quarterly figures. Suggestions to this effect have been made. *E.g., SEC Securities Act Release No. 5549 (Notice of Proposals to Increase Disclosure of Interim Results By Registrants)*, [Current] CCH Fed. Sec.L.Rep. ¶ 80,030 (Dec. 19, 1974); Sommer, *The Four Musts of Financial Reporting*, [1973-74 Transfer Binder] CCH Fed.Sec.L.Rep. ¶ 79,620 at 83,662-3-4 (January 1974).

Such a change will have profound impacts upon the accounting profession and its clients. Study and thought must be given to the wisdom of this change. The decision has not yet been made. It should not be compelled *ad hoc* by the erroneous charge in this case—and certainly should not be applied retroactively to events which occurred over five years ago.

2. The practice of accountancy, like the practice of other learned professions, is quintessentially the making of judgments. The opinion of the auditor speaks to fairness of presentation of the financial statements as a whole in accordance with generally accepted accounting principles. Despite common misuse of the adjective, the financial statements are not "certified". The opinion is based upon the performance of tests.

No representation of accuracy or precision is made. Testing is only that. However sound statistically, un-

discovered discrepancies may exist within the statistical universe. In the first and last analysis, the financial statements are those of the company, not of the auditors.*

Accounting principles seek both to reflect economic substance and to achieve uniformity of presentation so that financial statements may be usefully compared. The almost universally followed accrual method of accounting demands estimation and by hypothesis produces something less than certainty or precision.

The exercise of professional judgment cannot be avoided, and one of the unavoidable questions is that of materiality. The obvious necessity for judgments as to materiality is recognized by numerous SEC rules and regulations, the most directly relevant of which is Rule 3-02 of Regulation S-X, 17 C.F.R. 210.3-02 (1974), the accounting regulations of the SEC. Rule 3-02 tells an accountant:

> "If an amount which would otherwise be required to be shown with respect to any item is not material, it need not be separately set forth." **

Similarly, the controlling pronouncements of the accounting profession advise an accountant that the principles which ordinarily govern:

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* *See, e.g., In the Matter of Interstate Hosiery Mills, Inc.*, 4 S.E.C. 706, 721 (1939); *Accounting Series Release No. 62*, 17 C.F.R. Part 211-62 (1974), 4 CCH Fed.Sec.L.Rep. ¶ 72,081 at 62,149 (1947); AICPA, *Statements on Auditing Procedure No. 33* at 9-10, 12 (1963); AICPA, *Statement on Auditing Standards No. 1* at 1, 4 (1973).

** Section 23(a) of the Securities Exchange Act, 15 U.S.C. § 78w(a), provides that:

> "No provision of this chapter imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission . . . ."

> "have application only to items material and significant in the relative circumstances . . . . [I]tems of little or no consequence may be dealt with as expediency may suggest." *

That financial reporting is not precise and does involve judgments has also been recognized by the courts.**

The exercise of professional judgment concerning the question of materiality was a critical issue in this case. We will not repeat the many factors which led Mr. Natelli to decide, in consultation with Mr. Otkiss, that specific disclosure of the Michaels' write-offs in the challenged footnote was not required. The decision was made.

That decision was one of the two specifications of criminal wrongdoing—that a false or misleading statement with respect to a material fact had been willfully and knowingly made. The crucial issues were whether the omission was material *and* whether Mr. Natelli "knew" it was materially misleading. The trial court instructed the jury concerning

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* APB, *Accounting Principles* § 510.09 (1968). *See also* AICPA, *Statements on Auditing Procedure No. 33* at 17 (1963); AICPA, *Statement on Auditing Standards No. 1*, § 150.03-.04 at 6 (1973); AICPA, *Accounting Research and Terminology Bulletins*, at 9 (final ed. 1961); *Montgomery's Auditing* at 78 (8th ed. 1957); L. Rappaport, *SEC Accounting Practice and Procedure*, at 16-13-16-14 (3d ed. 1972).

** *See, e.g., Crane Co.* v. *Westinghouse Air Brake Co.*, 419 F.2d 787, 799-801 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970); *Colonial Realty Corp.* v. *Brunswick Corp.*, 337 F.Supp. 546, 552, 556-57 (S.D.N.Y. 1971); *Escott* v. *BarChris Construction Corp.*, 283 F.Supp. 643, 666, 681 (S.D.N.Y. 1968); *Kohler* v. *Kohler Co.*, 319 F.2d 634, 640 (7th Cir. 1963), *aff'g*, 208 F.Supp. 808, 818-19 (E.D.Wisc. 1962); *Independent Investor Protective League* v. *AVCO Corp.*, [Current] CCH Fed.Sec.L.Rep. ¶ 94,943 at 97,257 (S.D.N.Y. 1975); *Shamoon* v. *General Development Corp.*, [1973-74 Transfer Binder] CCH Fed.Sec.L.Rep. ¶ 94,308 at 95,039 (S.D. N.Y. 1973).

the first issue.* The trial court failed to instruct the jury concerning the second issue.

The trial court's instruction directed the jury to consider what would concern a reasonable person. Once the jury found that the omitted disclosure was such, the issue of materiality was foreclosed. The jury was not instructed to then address itself to the different issue of whether Mr. Natelli had honestly, if erroneously, concluded differently.

This charge and the conviction in this case pose a profoundly frightening prospect for accountants. By hypothesis, as we have said, auditors inescapably make judgments. We trust that it may be assumed that their judgments, although sometimes mistaken and sometimes the basis for civil liability are, in all but the rarest cases, honestly made. But this case may stand for the proposition that, in a criminal prosecution, the subjective honesty of a professional judgment is not pertinent if a lay jury finds that judgment objectively erroneous. *Mens rea* becomes immaterial to the determination of guilt or innocence.

This is simply not what the statutory provision under which appellants were indicted requires or what the indictment pleaded. Manifest prejudicial error was committed, which the Court should correct.

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* We believe the district court erred in this instruction as well. *Compare* the district court's test of "materiality" for the purpose of a statement made in a proxy statement, *i.e.*, whether a misstatement or omission would "matter to" or "concern" a "reasonable person" (Tr. 2368) *with* that of this Court, *i.e.*, whether there is "a substantial likelihood that the misstatement or omission" had "led a stockholder" to take action "whereas in the absence of this he would have taken a contrary course". *General Time Corp.* v. *Talley Indus., Inc.*, 403 F.2d 159, 162 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969). *See Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1302 (2d Cir. 1973); *Laurenzano* v. *Einbender*, 448 F.2d 1, 5 (2d Cir. 1971); *Crane Co.* v. *Westinghouse Air Brake Co.*, 419 F.2d 787, 799 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970).

CONCLUSION

We submit that for these and the other reasons detailed in the briefs on behalf of Mr. Natelli and Mr. Scansaroli, their convictions should be reversed and the indictment as to them dismissed.

Dated: New York, New York
March 3, 1975

Respectfully submitted,

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Of Counsel:

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and
WILLIAM E. HEGARTY
MATHIAS E. MONE
GEORGE WAILAND

APPENDIX

Affidavit of William E. Hegarty

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Docket No. 75-1004

UNITED STATES OF AMERICA,

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v.

ANTHONY M. NATELLI and JOSEPH SCANSAROLI,

Defendants-Appellants.

STATE OF NEW YORK }
COUNTY OF NEW YORK } ss.:

WILLIAM E. HEGARTY, being duly sworn, deposes and says:

1. I am a member of the Bar of this Court and of the firm of Cahill Gordon & Reindel, attorneys for Peat, Marwick, Mitchell & Co. ("PMM"). I submit this affidavit in support of PMM's motion for leave to file as *amicus curiae* the brief annexed hereto.

2. PMM seeks such permission to support the appeals of Mr. Natelli and Mr. Scansaroli, who at the time of the material events were, respectively, the partner-in-charge

of PMM's Washington, D.C. office and a professional employee of PMM in that office.*

3. Beyond this relationship and interest, PMM seeks such permission to stress two errors in the instructions of the trial court which, unless corrected by this Court, will, we believe, have a material, adverse and unwarranted impact upon the practice of the profession of accountancy. They are stated in the second page of the annexed brief.

4. PMM is one of the largest national accounting firms, with some 800 partners and principals and some 7,000 members of its professional staff. On behalf of these professionals, PMM has a most direct, immediate and real interest in the issues which are argued in the brief PMM seeks leave to file.

WHEREFORE, it is respectfully submitted that PMM should be granted permission to file as *amicus curiae* the brief annexed hereto.

s/ WILLIAM E. HEGARTY
(William E. Hegarty)

Sworn to before me this
3rd day of March, 1975.

s/ ROBERT R. CAWTHRA
Notary Public

[SEAL]

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* Following the conviction below, Mr. Natelli resigned his partnership but remains in a consulting capacity with PMM. Mr. Scansaroli left PMM's employ in September 1969 to take a position with National Student Marketing Corporation; more recently Mr. Scansaroli has practiced accounting with his brother in Johnstown, Pennsylvania. PMM has aided both Mr. Natelli and Mr. Scansaroli throughout in their defense of this criminal case. My firm represents them, and PMM, in related civil litigation in the United States District Court for the District of Columbia.

UNITED STATES COURT OF APPEALS

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Appellee, : AFFIDAVIT OF SERVICE

-against- : Docket No. 75-1004

ANTHONY M. NATELLI and JOSEPH SCANSAROLI, :

Defendants-Appellants. :

- x

STATE OF NEW YORK)
: ss.:
COUNTY OF NEW YORK)

ROBERT R. CAWTHRA, being duly sworn, deposes and says:

1. I am over the age of 18 years and not a party to this action.

2. On the 3rd day of March, 1975, I served the Notice of Motion and Amicus Brief of Peat, marwick Mitchell & Co. upon:

Paul J. Curran, Esq.
United States Attorney for the
Southern District of New York
Foley Square
New York, New York 10007

Attn: Franklin B. Velie, Esq.

Martin Obermaier & Morvillo
1290 Avenue of the Americas
New York, New York

Morrison, Paul, Stillman & Beily
110 East 59th Street
New York, New York

by causing two copies of the Brief and one copy of the Motion to be hand delivered to their offices at the above-mentioned addresses.

Robert R. Cawthorn

Sworn to before me this

3rd day of March, 1975

David G. Morrow

Notary Public

DAVID G. MORROW
Notary Public, State of New York
No. 31 4514749
Qualified in New York County
Commission Expires March 30, 1975

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FOR THE SECOND CIRCUIT

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